



# TACONIC VIEWS

Financial Insights for Secure Retirements and Life's Transitions

Spring 2012

## Financial Advisors' Hidden Conflicts of Interest

Bert Whitehead, M.B.A., J.D.  
Franklin, MI

Fee-only financial advisers have long held themselves out as being more ethical than commissioned stockbrokers. Fee-only advisers claim to adhere to a fiduciary standard which requires them to act in the best interest of their clients, meaning they must set aside their personal interest and fully disclose all of their fees and any conflicts of interest.

Stockbrokers, by comparison, must meet a much lower suitability standard, meaning they must make sure that investments sold are suitable for a client. Certainly, charging a client a fee based on the percentage of assets under management (AUM) reduces the conflicts of interest that a commission-based stockbroker faces when his livelihood depends on whether clients buy or sell securities. What's more, it often appears that stockbrokers are prone to recommend investments that carry higher commissions, which need not be disclosed.

Charging clients on an AUM basis, however, often presents more serious conflicts of interests than those faced by brokers because the conflicts may involve much more money than the value of a trade. Here are some typical situations where asset-based fee compensation poses conflicts for advisers:

- When advising a client to roll over a 401(k) for the adviser to manage, even when the client has equivalent and less costly options if they leave their funds with the employer's fund manager.
- When advising a client not to pay off a mortgage (thus diminishing assets), even when the mortgage carries a high interest rate.
- When advising against making a large charitable contribution to get a tax deduction (but decrease assets under management).
- When advising not to give large gifts to children to avoid estate taxes.
- When advising not to buy a larger home.

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## Make Sure You Buy and Are Not Sold

Michael Ryan, MBA  
Hendersonville, TN

Although I have never thought of myself as a particularly gifted salesperson, I have always enjoyed watching one at work. Good salespeople are artists, and volumes have been written about how to be one. If you Google "how to sell," you will get about 460 million responses. Selling is an old and honorable profession. If you have it, someone sold it, so I would never denigrate salespeople. But I do want to make some observations about how "selling" can have an impact on our financial lives.

The best salespeople are totally committed to their products. They see no gray areas; they see only that your life, as well as theirs, will be better once you buy their product. They allow no doubt to enter their minds and hopefully not yours. And salespeople are always selling. A good salesperson realizes that eventually someone always buys.

I was reminded of the effects of "selling" recently when I spoke with a friend. He had just endured the heartbreak of divorce and had been trying to get his financial life back in order. He asked me to look at his finances and offer suggestions. As I was reviewing his holdings, I noticed he owned an annuity. He was able to tell me what company had issued the annuity but not much else about it. He was not sure how much it was worth, how long the surrender period lasted, or what the surrender penalty would be. He was unaware that the IRS usually imposes a penalty on money withdrawn from annuities before the owner reaches age 59½. And more importantly, he did not know what he was trying

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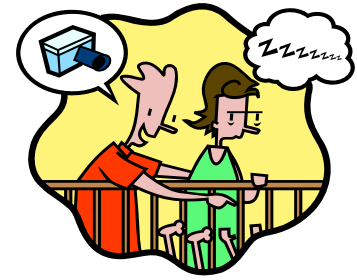
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Transitions...

## Financial Planning for Life's Transitions



### Advice for New Parents

Clare Emory, CFP®, CFA, MBA  
Arlington, VA

Becoming a parent is one of those transitions that tend to make you step back and think of the big picture. It's a chance to take stock and reassess your financial plan as you move into an exciting—and expensive—new phase of your life. Having a child not only shifts your emotional terrain, it alters the financial ground as well. The website <http://www.Babycenter.com> has an enlightening calculator that can give you a sense of how much it costs to raise a child in your region of the country, based on the range of your household income, whether you're single or a co-parent, live in a metropolitan or rural area, and whether you plan to pay for college. For example, a couple living in a city in New England, with an annual income of \$100,000 or higher and planning to pay for public college, will spend an average of \$499,400 from birth to age 18, including \$78,380 for public college. These figures are in 2010 dollars, adjusted for inflation, from the U.S. Department of Agriculture annual report "Expenditures on Children by Families."

Seeing those average expense figures may prompt you to take a close look at your savings habits. If you run into bumps in the road ahead (which happens to most of us sooner or later) do you have adequate liquidity to make it through the rough patches smoothly? Are you saving automatically for retirement from each paycheck or regularly putting money into a retirement account if you're self-employed? Your first thought with regard to long-term savings might be to worry about your child's college education...but funding your own retirement must take priority. Most likely, you'll be supporting yourself after you retire for far longer than your child will be in college, and you cannot take out a low-interest loan or qualify for a scholarship to fund your retirement years. If you're already maximizing your retirement contributions, you can think about taking the next step and starting a college fund, preferably funded by automatic monthly transfers.

Now is also a good time to review your insurance

coverage. None of us knows what the future may hold, and you want to be able to offer your child a financially secure upbringing no matter what happens. Do you have enough term life coverage to adequately replace your income if you were to die prematurely? Even more importantly, do you have sufficient disability coverage, preferably provided by or purchased through your employer? Losing income as a result of illness or injury is far more common than dying before retirement age and can compromise the lifestyle you hope to offer your child. According to the Social Security Administration, 3 of every 10 workers will become disabled at some point before reaching retirement. Most of those disabilities are due not to accidents but to relatively common chronic illnesses such as cancer, heart disease, and multiple sclerosis. Although a fair number of companies offer short-term disability coverage, not so many cover long-term disability.

Social Security only provides benefits to those who have been disabled for more than five months, whose disability is expected either to last a full year or end in death, and who are unable to work at *any* occupation. Multiple applications are usually required to qualify, and the benefits average around \$1,000 per month. It's worth checking with your employer to find out exactly what coverage is available to you, taking advantage of group coverage where possible and supplementing that with an individual policy if necessary to replace at least 60% of your income.

In the midst of the joy of birth, the prospect of death cannot be ignored. This new being depends on you completely, and part of your obligation is to ensure that he or she would be well taken care of if something were to happen to you. An up-to-date will is essential, with a primary guardian and backup guardian designated. Keep in mind that if you're married and your spouse dies without a will, you will not necessarily inherit all of the assets. Quite a few states have intestacy laws that divide the assets between the surviving spouse and any children of the marriage. Assets left to a minor child are

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## **Hidden Conflicts...** *Continued from page one*

- When advising not to buy an annuity or set up a charitable annuity.
- When advising a client not to invest in real estate.

The most egregious conflict of interest inherent in the AUM compensation model is the common practice of charging a higher fee — often 1.5% — for managing equities than for managing bonds and cash, which typically are managed for 0.5%. Advisers routinely justify the difference by claiming that equities are more complex investments to manage, which I find self-serving: why not just charge 1.0% for a balanced portfolio? As a result of this compensation difference, clients are almost always over-allocated to stocks.

In all the cases mentioned above there may be good and impartial reasons for an adviser's recommendation, but in all these cases and many others the temptation to protect or enhance the adviser's own compensation is too great.

These conflicts are magnified when an adviser claims to be a comprehensive financial planner rather than merely an investment adviser. Comprehensive financial planning includes more than overseeing asset allocation and making individual investments; it encompasses all financial aspects of a client's situation: estate planning, tax planning, insurance coverage, debt management (including mortgages) and more. Many comprehensive financial planners who charge a fee based on assets under management often give a short shrift to other aspects of a client's situation. After persuading a client to sign on, they may speak or meet with the client relatively rarely. This is what would be expected as people generally do what they are paid to do. If they are paid for gathering assets, that's what they focus on.

The National Association of Financial Advisors (NAPFA) has long championed the importance of commission-free financial and investment advice. The media has recognized their contribution in exposing unethical practices fostered by commission-based compensation. Now, however, most stockbrokers and fee-only advisers (including NAPFA members) charge fees based on AUM. In terms of compensation the two types of advisers have become indistinguishable. As a pioneer and current member of NAPFA, I believe that advisers who charge AUM fees fall short what should be expected of true fiduciaries.

The current NAPFA fiduciary standard limits adviser activity to the 'purchase or sale of a financial product' rather than 'any transaction.' A clear standard should require that an adviser's compensation not depend on any transaction where a client is relying on the adviser's counsel. The examples of conflict of

interest listed above all involve transactions that are not 'purchases or sales' of investments.

To avoid most conflicts of interest it is simple enough for advisers to charge a flat annual retainer fee that is not affected by a client's decisions regarding any specific transaction. The structure of a flat fee — which may be more or less than an AUM fee — insulates the adviser from any taint of conflict attributable to compensation. This pricing model is now well established as the minority trend in the profession with hundreds of successful practices having adopted this approach.

Ironically, as common as AUM is for compensation, it is a terrible business model. By tying themselves so closely to forces over which they have little control, excellent advisers can see their annual revenue plunge by 50% in down markets even though their workload is much greater. If advisers are, in fact, providing comprehensive advice and are not being compensated directly for their services, they are providing them for free. Nevertheless, AUM is an attractive pricing model, but for the wrong reasons. First, it is deceptive. "I charge 1.5% of assets I manage, so I only make more money if you do" is an enticing but misleading sales pitch. Most people can't or don't do the math, and don't realize that 1.5% of \$1 million amounts to \$15,000 a year — a fee they likely would resist paying if it were transparently stated as a dollar amount rather than as a percentage. Moreover, AUM fees are deducted directly from a client's account, and so the fee is seldom overtly seen.

A strict ethical approach would require that these potential conflicts be disclosed at the time of engagement, and again whenever an advisor's specific recommendation may be construed as a conflict of interest. When a situation involves an egregious conflict of interest, such as advising an investment in the adviser's own investment schemes, an adviser should be required to recuse himself and recommend that the client get a second opinion — a practice common in other professions.

If fee-only advisers want to hold themselves out as being the most ethical practitioners of their profession, they should commit themselves to adhering to the highest possible — and least conflicted — standard.

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*Note: Bert Whitehead, the President of Cambridge Connection Inc. and founder of ACA, is the author of "Why Smart People Do Stupid Things with Money" (Sterling, 2009). He wrote this as an editorial for Investment News Weekly, which prompted a heated discussion in the on-line Wall Street Journal. It also appears on his blog at [bertwhitehead.com](http://bertwhitehead.com).*



to accomplish when he had acquired the annuity. In other words, he was “sold” the annuity.

This scenario happens all too often with financial products. Unless consumers educate themselves before talking with a good salesperson, they may find themselves being sold a product they do not need that will not accomplish what they want to accomplish. If a product is sold, the salesperson’s interests and biases may play a bigger role than the consumer’s actual needs.

If you cannot explain a financial product fairly succinctly to someone else, you may not need it. Most financial products that we as consumers really need are straightforward and logical; they make sense. We can understand what we are getting and what we are trying to accomplish when we buy them. If you have to be sold a product, a product that you cannot easily understand or explain, you very likely do not need it as much as the salesperson needs to sell it.

If you have questions, try contacting a member of the Alliance of Cambridge Advisors (or another highly experienced fee-only advisor) to determine whether you are “buying” or being “sold” a financial product.

then administered by a court-appointed guardian under court supervision until the child reaches age 18 or 21, depending on the state.

Choosing a guardian is often a difficult task for parents and easy to put off. Ask yourself: Who would you prefer make the decision of who will raise your child if you were to die prematurely - you or whichever judge happens to get the case if you die without having designated a guardian? Yes, it’s a hard decision, but you’ll feel much better once you’ve made it. If you don’t have family or aren’t comfortable designating a family member, think about who would be likely to raise your child with the values and lifestyle most congruent with your own. And keep in mind that the designation isn’t etched in stone for the next 18 years: you can revise it later if circumstances change.

Don’t forget that your new little bundle needs a Social Security number. If you didn’t deliver in a hospital or weren’t given a form after the birth, contact your local Social Security Administration office. A Social Security number is needed to claim child-related tax breaks, to add your baby to your health insurance plan, to set up a college savings plan, and for various other purposes. Once you know you have all your financial ducks in a row, you can focus on making the most of your new expanded family life.



## The Fear of Budgeting

Ken Robinson, JD, CFP®, AIF  
Cleveland, OH

Have you ever worried about money? Chances are you have. And you probably weren't concerned you'd have too much. Worry about money is usually an expression of fear that we won't have enough.

I often speak to groups about how to save more money out of every paycheck. At one presentation a few years ago, my host had introduced me and I was just stepping up to the lectern. But before I could say anything, someone from the audience spoke up:

"I'm *not* giving up my cell phone!"

This guy was nervous that I'd say he couldn't keep this expensive part of his life. Those seven words—"I'm *not* giving up my cell phone" speak volumes about why saving is often so difficult.

Fear and anxiety are common reactions to the subject of budgeting. Many people are concerned they won't have enough money to buy basic necessities. Although this is true for lots of families, many others believe they are in this category when they're actually not. If a family buys a wide-screen TV and then complains about being short of cash, chances are their problem isn't that they have too little money available.

Even so, those with much more than they need for their survival often resist the call to save money. It's not that they don't know how. Almost every adult has heard of a budget and could probably explain to you how it works. So what makes budgeting so uncomfortable that many prefer to tolerate being frightened about not having enough money?

Consider what the budgeting process asks people to do. They're supposed to examine all their spending and determine how much goes for food, rent, transportation, entertainment, and every other category in their lives. Many budgeters don't want to face what they'll learn. "I've been afraid to look at how much we spend eating at restaurants," a client told me recently. He knows it's too much, but it's more painful to actually know the amount than to remain willfully ignorant, even though frequent



eating out leaves him unable to save as much as he'd like.

Even if budgeters don't think they're spending more than they should, they're already thinking, "I'm *not* giving up my cell phone." Because after they identify all their spending, they know what's coming next: they have to decide where they can cut back, what they can do without. The unpleasantness of having to do this can dwarf the danger of not being able to pay all their bills or not being able to save for their own self-sufficiency.

Even worse than the risk of giving up things we want; budgeting is a threat to the way we are viewed by others, as well as how we tend to see ourselves. Our culture teaches us that who we are is largely determined by what we possess and what we show to the rest of the world. Of course, we all know there are qualities about us that are far more important than money or possessions.

But most of us want to be like the people we hang out with and the people we'd *like* hang out with (although this strong need often goes unrecognized). When budgeters decide "I can't afford that," it can feel like an attack on their sense of themselves and their very idea of who they are or who they thought they could be.

This is the most significant roadblock to budgeting. It's not the saving that bothers people. For powerful (often unconscious) reasons, the problem is facing up to the cutbacks needed to achieve the savings. It's like that old joke about the man who lost his balance and nearly fell off the roof. "It's not the fall that would bother me," he said. "It's the sudden stop at the end."

The difficulty with budgeting is why so many advisors prefer to have their clients *pay themselves first*. If you're meeting your bills and saving enough for your future goals, very often it doesn't matter where the rest goes.

You probably would benefit from making a traditional budget. But for those who can't budget or find it too painful, saving money is not a lost cause. Putting money aside out of every paycheck as soon as you get paid is often the most effective way to fund your future goals.

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